[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOL) BETWEEN THE UNITED STATES AND THE RUSSIAN FEDERATION

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON OCTOBER 27, 1993

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

OCTOBER 26, 1993

U.S. GOVERNMENT PRINTING OFFICE
73-303 WASHINGTON : 1993 JCS-17-93

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-041714-7

JOINT COMMITTEE ON TAXATION

103D CONGRESS, 1ST SESSION

CONTENTS

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty, as modified by the proposed protocol, between the United States and the Russian Federation ("Russia"). The proposed treaty and proposed protocol were both signed on June 17, 1992. Currently, the United States and Russia adhere to the provisions of a tax treaty signed June 20, 1973 between the Soviet Union and the United States (the "USSR treaty"). The proposed treaty would replace the USSR treaty with respect to Russia.[2] The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty (and protocol) on October 27, 1993.

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty (the "U.S. model"), and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed treaty contains certain deviations from those documents.

Part I of the pamphlet summarizes the principal provisions of the proposed treaty and protocol. Part II presents a discussion of issues that the proposed treaty presents. Part III provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in Part IV by a detailed, article-by-article explanation of the proposed treaty and protocol.[3]

---

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty and Proposed Protocol Between the United States and the Russian Federation* (JCS-17-93) October 26, 1993.

[2] Adherence to the USSR treaty as between the United States and other former republics of the Soviet Union would not be altered by entry into force of the proposed treaty between the United States and Russia.

[3] For a copy of the proposed tax treaty and protocol, see Senate Treaty Doc. 102-39, September 8, 1992.

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and Russia are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the two countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard treaty provisions that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 13). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 13, 14, and 16). The proposed treaty provides that dividends derived by a resident of either country from sources within the other country generally may be taxed by both countries (Article 10). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit (Article 22).

The treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 1). In addition, the treaty contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries (Article 1); that is, the treaty will only be applied to the benefit of taxpayers.

Differences among proposed treaty, USSR treaty, and model treaties

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model treaty. It also differs in significant respects from the treaty with the Soviet Union. (That treaty predates the 1981 U.S. model treaty.) Some of these differences are as follows:

(1) Like all treaties, the proposed treaty is limited by a "saving clause," under which the treaty is not to affect (subject to specific exceptions) the taxation by either treaty country of its residents or its nationals. Exceptions to the saving clause are similar to those in the U.S. model and other U.S. treaties; the USSR treaty, in contrast, flatly states that it shall not restrict the right of a treaty country to tax its own citizens.

(2) The U.S. excise tax on insurance premiums paid to a foreign insurer is not a covered tax; that is, the proposed treaty would not preclude the imposition of the tax on insurance premiums paid to Russian insurers. This is a departure from the USSR treaty and the U.S. model tax treaty, but one that is shared by many U.S. treaties, including recent ones. In addition, the proposed treaty, like the model treaty but unlike the USSR treaty, does not contain a general prohibition on source country taxation of reinsurance premiums derived by a resident of the other country. Nor does the proposed treaty contain the provision of the USSR treaty under which, if the income of a resident of one country is tax-exempt in the other country, the transaction giving rise to that income is exempt from any tax that is or may otherwise be imposed on the transaction. (It is understood that this provision applies to the insurance premium excise tax, and does not apply to customs duties.)

(3) Like the U.S. model but unlike the USSR treaty, the proposed treaty generally does not cover U.S. taxes other than income taxes, although it does cover capital taxes and excise taxes with respect to private foundations. Nor does the proposed treaty cover the accumulated earnings tax, the personal holding company tax, and social security taxes.

(4) The proposed treaty makes it clear that each country includes its territorial sea, and also the economic zone and continental shelf in which certain sovereign rights and jurisdiction may be exercised in accordance with international law.

(5) By contrast with the USSR treaty, but like the U.S. model, U.S. citizens are entitled to treaty benefits regardless of actual residence in a third country. In addition, the proposed treaty introduces rules for determining when a person is a resident of either the United States or Russia, and hence entitled to benefits under the treaty. The proposed treaty, like the model, provides tie-breaker rules for determining the residence for treaty purposes of "dual residents," or persons having residence status under the internal laws of each of the treaty countries.

(6) Under the proposed treaty, any corporate dual resident will be treated as a resident of one or the other country only if the competent authorities can agree; if not, the proposed treaty (unlike the U.S. model) expressly provides that the company shall be treated as a resident of neither country for purposes of enjoying treaty benefits, and hence is entitled to no treaty benefits.

(7) The proposed treaty introduces the permanent establishment threshold for one country's imposition of tax on the business profits of a resident of the other country, in conformity with the U.S. and OECD model treaties. This replaces the concept of a "representation" used in the USSR treaty.

(8) Under the U.S. model treaty, a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, constitutes a permanent establishment only if it lasts more than 12 months. The corresponding rule in the proposed treaty extends that time period to 18 months. Under the USSR treaty, the source country is prohibited from taxing the income of a resident of the other country from furnishing engineering, architectural, designing, and other technical services in connection with an installation contract with a resident of the source country and which are carried out in a period not longer than 36 months at one location. Thus, while the proposed treaty represents a move in the direction of the U.S. model, it allows source country taxation under some circumstances now forbidden.

(9) The proposed treaty provides that the maintenance of a fixed place of business by a person solely for the purpose of facilitating the conclusion (or for the mere signing) of contracts in the name of the person, concerning loans or the delivery of goods or merchandise or technical services, is an activity that will not be treated as carried on through a permanent establishment. The model treaties do not address this type of activity specifically.

(10) The business profits article of the proposed treaty overrides the force of attraction rules contained in the Code, providing instead that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. This is consistent with the U.S. model treaty.

(11) The proposed treaty clarifies that a country may tax profits or income if the other-country resident carries on "or has carried on" business, or has "or had" a fixed base, in that country. Addition of the words "or has carried on" and "or had" clarifies that, for purposes of the treaty rules stated above, any income attributable to a permanent establishment (or fixed base) during its existence is taxable in the country where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) has ceased to exist.

(12) The proposed protocol provides that, in allowing interest deductions from the taxable income of a permanent establishment, Russia will permit a Russian permanent establishment of a U.S. resident to deduct interest, whether paid to a bank or another person, and without regard to the period of the loan. However, unlike the model treaty or the USSR treaty, the proposed treaty provides that the deduction may not exceed the limitation under Russian tax law, as long as the limitation is not less than the London Interbank Offered Rate ("LIBOR") plus a reasonable risk premium to be provided for in the loan agreement.

(13) The proposed treaty includes an article corresponding to the associated enterprises article in the U.S. model treaty. In particular, the proposed treaty contains a "correlative adjustment" clause,

providing that either treaty country must correlatively adjust any tax liability it previously imposed on a person for income reallocated to a related person by the other treaty country. The USSR treaty contains no associated enterprises article.

(14) The proposed treaty, similar to the model treaty and similar in some respects to the USSR treaty, provides that income of a resident of one treaty country from the operation of ships or aircraft in international traffic is taxable only in that country. (The corresponding model treaty provision applies to "profits" from such operation, while the English version of the proposed treaty applies to "income.") Similar to the model treaty, the proposed treaty includes bareboat leasing income in the category of income to which this rule applies. Similar to the model treaty and unlike the present treaty, the proposed treaty provides that income of a treaty-country resident from the use or rental of containers and related equipment used in international traffic shall be taxable only in that country.

(15) The USSR treaty in general imposes no restriction on the taxation of income from real property by the country in which the property is located. The proposed treaty contains a provision similar to the model treaty provision permitting taxation of such income by the country in which the real property is located, including the U.S. model treaty provision under which investors in real property in the country not of their residence must be permitted to elect to be taxed on those investments on a net basis.

(16) The USSR treaty generally imposes no restriction on the source-country taxation of dividends. The proposed treaty, similar to the U.S. model treaty, provides that direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting shares of the payor) will generally be taxable by the source country at a rate no greater than 5 percent. Like recent U.S. treaties, the proposed protocol provides that the 5 percent limit does not apply to dividends paid by a U.S. regulated investment company (a "RIC").

(17) Under the proposed treaty, portfolio investment dividends (i.e., those paid to companies owning less than a 10 percent voting share interest in the payor, or to noncorporate residents of the other country) are generally taxable by the source country at a rate no greater than 10 percent. This is a significantly tighter restriction than that in the model treaties and other U.S. treaties (with the exception of those with China and Romania), which generally permit source country taxation of at least 15 percent on portfolio dividends. (It could be argued that, in effect, France, Germany, and the United Kingdom are required under their treaties with the United States to retain somewhat less shareholder-level tax in the corresponding case; the United States is not so required under those treaties.) Similar to recent U.S. treaties, on the other hand, the proposed treaty imposes no general restriction on the source country taxation of dividends paid by a U.S. real estate investment trust (a "REIT").

(18) The USSR treaty generally imposes no restriction on the U.S. branch profits tax. The proposed treaty, similar to U.S. treaties negotiated since 1986, expressly permits the United States to

impose the branch profits tax, but at a rate not exceeding 5 percent.

(19) The USSR treaty generally imposes a restriction on the source-country taxation of interest, but only in the case of interest in connection with the financing of trade between the United States and the Soviet Union. The proposed treaty, like the U.S. model and numerous U.S. treaties, generally prohibits source country taxation on interest. However, the proposed treaty provides that income from any arrangement, including a debt obligation, carrying the right to participate in profits and treated as a dividend by the source country according to its internal laws, may be taxed by the source country as a dividend. Thus, for example, the country of source could withhold tax on deductible interest paid under an "equity kicker" loan, at rates applicable to dividends. There is no similar provision in the U.S. or OECD models.

(20) The proposed protocol provides that the interest article in the proposed treaty does not interfere with the jurisdiction of the United States to tax under its internal law an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (a "REMIC"). Currently, internal U.S. law applies regardless of treaties that were in force when the REMIC provisions were enacted.

(21) Like the model treaty and similar to the USSR treaty, the proposed treaty provides that royalties derived and beneficially owned by a resident of a country generally may be taxed only by that country. Royalties are defined as payments for the use of certain rights, property, or information. Unlike the model treaty, the proposed treaty does not treat as royalties gains from the alienation of rights or property which are contingent on the productivity, use, or further alienation of such right or property. The taxation of such gains is governed by the proposed treaty's "Other Income" article, which, in a manner similar to the royalties article, generally reserves taxing jurisdiction to the residence country.

(22) Unlike the U.S. model treaty, the proposed treaty has no "Gains" article. The USSR treaty generally imposes restrictions on the source-country taxation of gains only in the case of certain ships or aircraft operated in international traffic, property received by inheritance or gift, and gains from the disposition of either industrial, commercial, or scientific equipment, or certain intangible property. The "Other Income" article on the proposed treaty would appear to permit a treaty country to tax gains of a resident of the other country to the same extent allowed under the U.S. model treaty, taking into account both the Gains and Other Income articles of the U.S. model:

> Similar to the U.S. model treaty, the proposed treaty does not restrict the jurisdiction of a treaty country to tax gains from the alienation of real property situated in that country, and from stock in a company at least 50 percent of the assets of which consist of real property situated there. As provided in the proposed protocol, this safeguards U.S. tax under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), which applies to dispositions of U.S. real property interests by nonresident aliens and foreign corporations.

The proposed treaty generally permits taxation by a treaty country of income of a resident of the other treaty country—other than business profits, dividends, interest, royalties, shipping income, and income from real property, personal services, directors' fees, and pensions—attributable to a permanent establishment or fixed base in the first country. The Treasury Department has indicated that this permits the taxation of gains from the alienation of a permanent establishment or fixed base, or gains from the alienation of personal property which are attributable to a permanent establishment or fixed base, as provided for in the U.S. model.

(23) The proposed treaty generally restricts, to a greater extent than the U.S. and OECD model treaties, and numerous U.S. treaties, source country taxation of income of an individual resident of the other treaty country from performing independent personal services. In addition to the restrictions provided by the model treaty, the proposed treaty, like the USSR treaty, conditions taxation in this case upon presence of the individual in the source country for more than 183 days. Otherwise the proposed treaty is similar to the U.S. model treaty.

(24) The proposed treaty generally also restricts source country taxation of employment income to a greater extent than the U.S. and OECD model treaties, and numerous U.S. treaties. Under the proposed treaty, as under the models, income from employment in one country (the source country) by a resident of the other country is not taxable by the source country if the individual is in the source country fewer than 184 days during the year, the employer is not a resident of the source country, and the compensation is not borne by a permanent establishment or fixed base of the employer in the source country. Consistent with the USSR treaty and the models, the source country may not tax compensation derived from employment as a member of the regular complement of a ship or aircraft operated in international traffic. Unlike the models, the proposed treaty prohibits source country taxation if the employment is directly connected with a place of business which is not a permanent establishment, and the employee is present in the source country 12 consecutive months or less. In addition, the proposed treaty prohibits source country taxation of employment income from providing technical services directly connected with the application of a right or property generating a royalty, if the services are provided under a contract for the use of the right or property. The USSR treaty generally exempts from source country tax the personal service income of an individual resident of the other country if he or she is not present in the source country more than 183 days of the year; and it exempts from source country tax the remuneration from abroad of a resident of the other country temporarily present, up to one year, to perform technical services as an employee of, or under contract with, a resident of the other country.

(25) Notwithstanding the above restrictions on source country taxation of income from personal services, the proposed treaty, like the OECD model treaty, allows directors' fees and similar payments made by a company resident in one country to a resident of

the other country to be taxed in the first country. The U.S. model treaty, on the other hand, treats directors' fees as personal service income. Under the U.S. model treaty the country where the recipient resides generally has primary taxing jurisdiction over personal service income and the source country tax on directors' fees is limited.

(26) The proposed treaty omits the U.S. model treaty reservation to the source country of jurisdiction to tax an entertainer or athlete, residing in the other country, who earns more than $20,000 in the source country during a taxable year, without regard to the existence of a fixed base or other contacts with the source country.

(27) Unlike the U.S. model treaty, the proposed treaty makes no special provision for the treatment of annuities, alimony, or child support payments. Taking into account the "Other Income" article, the result in the case of annuities and alimony is generally similar to that under the model; the result in the case of child support may not be.

(28) The proposed treaty, like the U.S. model treaty and unlike the USSR treaty, expressly provides for the taxation of pensions in general only by the residence country, and for the taxation of social security benefits and other public pensions not arising from government service only in the source country.

(29) The proposed treaty modifies the USSR treaty's rule, similar to the U.S. model rule, that compensation paid by a treaty country government to one of its citizens for services rendered to that government in the discharge of governmental functions may only be taxed by that government's country. Under the proposed treaty, as under the OECD model treaty and other U.S. treaties, such compensation generally may only be taxed by the recipient's country of residence, if the recipient is a citizen of that country, or (in the case of remuneration other than a pension) did not become a resident of that country solely for the purpose of rendering the services.

(30) The USSR treaty, unlike the models, precludes each country from taxing a resident of the other country who is temporarily present in the first country as a journalist, media correspondent, teacher, or researcher; or who is temporarily present to participate in an exchange program for intergovernmental cooperation in science and technology, or to study or gain technical, professional, or commercial experience. These exemptions generally extend only to income or allowances connected with the purpose of the visit, and only for such period as is required to effectuate the purpose of the visit, and in no case more than 2 years in the case of teachers and researchers, 5 years in the case of students, and one year in other cases.

The proposed treaty contains a less restrictive set of limitations on host-country taxation of temporary visitors. They do not apply to visits purely for teaching. The proposed treaty prohibits the host country from taxing certain payments from abroad for the purpose of the individual's maintenance, education, study, research, or training. Temporary presence in the host country must be for the purpose of studying at an educational institution; training as required to practice a profession; or studying or doing research as a recipient of a grant from a governmental, religious, charitable, scientific, literary, or educational organization. In the last case, the

proposed treaty prohibits the host country from taxing the grant. As under the USSR treaty, the exemptions apply no longer than the period of time ordinarily necessary to complete the study, training or research. Moreover, no exemption for training or research will extend for a period exceeding five years. The exemption from host country tax does not apply to income from research if the research is undertaken for private benefit.

(31) The proposed treaty, unlike the USSR treaty, contains a version of the standard "other income" article, found in the model treaties and some existing treaties, such as the U.S. treaty with the United Kingdom, under which income not dealt with in another treaty article generally may be taxed only by the residence country.

(32) The proposed treaty contains a limitation on benefits, or "anti-treaty shopping," article similar to the limitation on benefits articles contained in recent U.S. treaties and protocols and in the branch tax provisions of the Code. The USSR treaty has no such article.

(33) Unlike most U.S. treaties and the model treaties, the USSR treaty has no provision providing relief from double taxation. In the general case this absence may have little or no impact on a U.S. person, as the United States provides relief from double taxation by internal law, through the foreign tax credit. The proposed treaty provides that each country shall allow its residents (and the United States its citizens) a credit for income taxes imposed by the other country. However, such credits need only be in accordance with the provisions and subject to the limitations of internal law (as it may be amended from time to time without changing the general principle that credits must be allowed).

(34) The proposed protocol provides an additional credit rule for a U.S. citizen who is a Russian resident. To such a person Russia must allow credits even for U.S. taxes imposed solely by reason of the person's citizenship, but to no greater extent than the Russian tax on income from sources outside Russia.

(35) U.S. law allows taxpayers credit for foreign taxes only if the foreign taxes are directed at the taxpayer's *net* gain. Thus the sufficiency of deductions allowed under foreign law is relevant to the creditability of foreign tax against U.S. tax liability. At times, Soviet and Russian law have in effect placed significant restrictions on labor and interest cost deductions. In order to assist U.S. taxpayers' ability to take U.S. credits for Russian taxes, Russia would agree under the proposed protocol to permit certain Russian entities certain interest and labor cost deductions, regardless of its internal law, if U.S. residents beneficially own at least 30 percent of the entity, and the entity has total corporate capital of at least $100,000.

(36) The proposed treaty greatly expands the non-discrimination rule in the USSR treaty, in some respects conforming it to the U.S. model, and in other respects providing additional benefits. The USSR treaty requires "national treatment" to the extent of prohibiting discrimination under the laws of one country against citizens of the other country resident in the first country. It requires "most-favored-nation treatment" to the extent of prohibiting less favorable treatment, under the laws of one country, of citizens of the other country resident in the first country, or of local representa-

tions of residents of the other country, than the treatment afforded to third-country citizens and representations of third-country residents. The proposed treaty requires both "national treatment" to the extent required in the U.S. model *and* a form of "most-favored-nation treatment" (not taking into account special agreements, such as bilateral income tax treaties, with third countries) to be applied to citizens and residents of the treaty countries. The proposed treaty affords these benefits to citizens of the other country in the same circumstances as citizens of the first country, regardless of residence; to the local permanent establishments of residents of the other country, and to enterprises owned by residents of the other country. In addition, the proposed treaty prohibits discrimination against the deductibility of amounts paid to residents of the other country.

(37) Like the U.S. model treaty, and unlike the USSR treaty, the proposed treaty makes express provision for the competent authorities to mutually agree on topics that would arise under the proposed treaty, but are not mentioned in the present treaty's mutual agreement article, such as the characterization of particular items of income, the common meaning of a term, the application of procedural aspects of internal law, and the elimination of double taxation in cases not provided for in the treaty.

(38) While the USSR treaty requires exchanges of information only to the extent of providing information about changes in internal law, the proposed treaty includes the standard exchange of information article, similar to that in the U.S. model, which contemplates that each competent authority will assist the other in obtaining and transmitting information that relates to the assessment, collection, enforcement, and prosecution of tax claims against particular taxpayers. The proposed treaty omits the U.S. model provision pledging assistance in collecting such amounts as may be necessary to ensure that treaty relief does not enure to the benefit of persons not entitled thereto.

(39) The proposed protocol expressly provides that where the treaty limits the right to collect taxes, which taxes are nevertheless withheld at source at the rates provided for under internal law, refunds will be made in a timely manner on application by the taxpayer.

(40) During the first taxable year in which the proposed treaty is in effect, taxpayers may elect to be taxed instead as if the USSR treaty continued to have effect.

II. ISSUES

The proposed treaty, as amended by the proposed protocol, presents the following specific issues.

(1) Portfolio dividend withholding

The proposed treaty, like the pending treaty with Mexico, limits to 5 percent the source tax on direct investment dividends, and generally limits to 10 percent the source tax on other dividends. By contrast, U.S. treaty policy, as reflected in the U.S. model treaty, generally has been to retain the right to impose full corporate tax on U.S. corporations, plus a tax of 15 percent on "portfolio" dividends. Aside from the U.S. income tax treaties with China and Romania, U.S. treaties in force allow the source country to withhold at least a 15-percent tax on a portfolio dividend paid to a resident of the other treaty country.[4] U.S. treaty partners that have corporate tax systems at least partially integrated with individual-level taxes may either impose no withholding tax on dividends (by internal law or treaty), may impose lower rates, or may afford foreign portfolio investors with integration-related benefits for corporate taxes paid by the distributing corporation. The staff understands that Russia has entered into treaties with other countries that eliminate Russian withholding tax on dividends. It may be that U.S. investors seeking to invest in Russian enterprises may attempt to gain the benefit of those treaties by "treaty shopping" (see discussion below).

The Committee may wish to consider whether the 10-percent limit on portfolio dividends is appropriate as a matter of U.S. treaty policy generally, or whether it is appropriate in this case even if not in the general case. It may be that portfolio investment in Russian corporations by U.S. residents will, for the foreseeable future, be greater than portfolio investment by Russian residents in U.S. corporations. In that case, the reduction in Russian and U.S. tax would primarily reduce Russian rather than U.S. revenues. On the other hand, it may be theoretically possible that foreign investors would seek to use a treaty like the Russian treaty to obtain U.S. tax reductions not available under many other treaties. If Russian law were to make such treaty-shopping profitable, and the proposed treaty's limitation on benefits article sufficiently porous to allow treaty benefits in such a case, then the proposed treaty might have a detrimental influence on the other policy goals of the U.S. income tax treaty program.

---

[4] The U.S. treaties with China and Romania generally allow source taxation of any dividend at 10 percent, but no more than 10 percent.

(2) Treaty shopping

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty is intended to benefit residents of Russia and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of tax by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing in that treaty country a subsidiary, trust, or other investing entity which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties, including the treaties that are the subject of this hearing. Some aspects of the provision, however, differ either from an anti-treaty shopping provision proposed at the time that the U.S. model treaty was proposed, or from the anti-treaty shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty shopping provision of the treaty effectively forestalls potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in one version proposed with the U.S. model. That U.S. model proposal allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like several newer treaties and an anti-treaty shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, this safe harbor is considerably easier to enter, under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty shopping article differs from the comparable rule in some earlier U.S. treaties and proposed model provisions, but the effect of the change is less clear. The general test applied by those treaties to allow benefits, short of meeting the bright-line ownership and base erosion test, is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct

of a trade or business. (However, this active trade or business test does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty gives the competent authority of the source country the ability to override this standard. The Technical Explanation accompanying the treaty provides some elaboration as to how these rules will be applied.

The practical difference between the proposed treaty tests and the earlier tests will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed treaty could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty tests (i.e., would operate to deny benefits in potentially abusive situations more often).

In the past, the Committee has stated its belief that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible. The Committee has further expressed its concern that, in exercising any latitude Treasury has to adjust the operation of the proposed treaty, the rules as applied should adequately deter treaty shopping abuses. The USSR treaty does not contain anti-treaty shopping rules. Further, the proposed anti-treaty shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Russia since third-country investors may be unwilling to share ownership of such investing entities on a 50-50 basis with U.S. or Russian residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. The base erosion test provides protection from certain potential abuses of a Russian conduit. Finally, Russia imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use Russian entities to make U.S. investments. On the other hand, implementation of the tests for treaty shopping set forth in the treaty may raise factual, administrative, or other issues that cannot currently be foreseen. Thus, the Committee may wish to satisfy itself that the provision as proposed is an adequate tool for preventing possible treaty-shopping abuses in the future.

(3) Deductions under Russian law

To be creditable under the limitations of U.S. law, a foreign tax must be directed at the taxpayer's net gain. Like any foreign tax, the Russian tax imposed under the law "on Taxes on Profits from Enterprises and Organizations" (the entity profits tax) has been imposed on a base that is not necessarily identical to the U.S. income tax base. For example, in the past, in order to calculate taxable profit under this Russian law, gross profit was generally increased by certain labor costs in excess of a ceiling. In calculating taxable profit under the entity tax, interest deductions have in the past been limited in ways that are significantly more restrictive

than U.S. law. In order to assist U.S. taxpayers seeking eligibility of Russian taxes for use as credits against U.S. income, the proposed treaty requires Russia to provide interest and labor cost deductions; the proposed treaty does not, on the other hand, guarantee that any Russian tax will be creditable for U.S. purposes.

It generally has not in the past been consistent with U.S. tax policy for deductions from the U.S. tax base of a U.S. person to be granted by treaty. Nor has it been consistent with U.S. tax policy to guarantee by treaty the U.S. creditability of an otherwise noncreditable foreign tax. It is believed that both functions are generally more appropriately served in the normal course of internal U.S. tax legislation. The proposed treaty appears to be consistent with these principles, while accommodating the differences between Russia's and the United States's internal constitutional processes. As a result, the treaty does commit Russia to altering its internal tax base with respect to foreign-owned investments, while U.S. persons are not guaranteed that the treaty-modified Russian tax is creditable.

(4) Related persons and permanent establishments

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to reallocate profits among related persons residing in each country, if a reallocation is necessary to reflect the conditions which would have been made between independent persons. In addition, the proposed treaty requires each country to attribute to a permanent establishment the profits which it might be expected to make if it were a distinct and separate person. The Code, under section 482, provides the Secretary of the Treasury the power to make reallocations wherever necessary in order to prevent evasion of taxes or clearly to reflect the income of related enterprises. Under regulations, the Treasury Department implements this authority using an arm's-length standard, and has indicated its belief that the standard it applies is fully consistent with the proposed treaty. A significant function of this authority is to ensure that the United States asserts taxing jurisdiction over its fair share of the worldwide income of a multinational enterprise.

Some have argued in the recent past that the IRS has not performed adequately in this area. Some have argued that the IRS cannot be expected to do so using its current approach. They argue that the approach now set forth in the regulations is impracticable, and that the Treasury Department should adopt a different approach, under the authority of section 482, for measuring the U.S. share of multinational income.[5] Some prefer a so-called "formulary apportionment," which can take a variety of forms. The general thrust of formulary apportionment is to first measure total profit of a person or group of related persons without regard to geography, and only then to apportion the total, using a mathematical formula, among the tax jurisdictions that claim primary taxing

[5] See generally *The Breakdown of IRS Tax Enforcement Regarding Multinational Corporations: Revenue Losses, Excessive Litigation, and Unfair Burdens for U.S. Producers: Hearing Before the Senate Committee on Governmental Affairs,* 103d Cong., 1st Sess. (1993) (hereinafter, *Hearing Before the Senate Committee on Governmental Affairs*).

rights over portions of the whole. Some prefer an approach that is based on the expectation that an investor generally will insist on a minimum return on investment or sales.[6]

A debate exists whether an alternative to the Treasury Department's current approach would violate the arm's-length standard embodied in Article 9 of the proposed treaty, or the nondiscrimination rules embodied in Article 23.[7] Some, who advocate a change in internal U.S. tax policy in favor of an alternative method, fear that U.S. obligations under treaties such as the proposed treaty would be cited as obstacles to change. The issue is whether the United States should enter into agreements that might conflict with a move to an alternative approach in the future, and if not, the degree to which U.S. obligations under the proposed treaty would in fact conflict with such a move.

---

[6] See *Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means*, 101st Cong., 2d Sess. 360-61 (1990) (statement of James E. Wheeler); H.R. 460, 461, and 500, 103d Cong., 1st Sess. (1993); sec. 304 of H.R. 5270, 102d Cong., 2d Sess. (1992) (introduced bills); see also *Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearing Before the Subcommittee on Oversight of the House Committe on Ways and Means*, 102d Cong., 2d Sess. (1992).

[7] Compare *Hearing Before the Senate Committee on Governmental Affairs* at 26, 28. ("I do not believe that the apportionment method is barred by any tax treaty that United States has now entered into.") (statement of Louis M. Kauder) *with* a recent statement conveyed by foreign governments to the U.S. State Department that "[w]orldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States" (letter dated 14 October 1993 from Robin Renwick, U.K. Ambassador to the United States, to Warren Christopher, U.S. Secretary of State). See also *Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Committee on Ways and Means*, 102d Cong., 2d Sess. 224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department).

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States generally taxes nonresident alien individuals and foreign corporations on their U.S. source income that is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and, in certain limited situations on foreign source income, that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income").

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch-level excess interest tax, which amounts to 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (generally including interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such persons, the tax is 1 or 4 percent of the premium paid. These taxes generally are collected by means of withholding (hence these taxes are often called "withholding taxes").

Withholding taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. In addition, certain statutory exemptions from withholding taxes are provided. For example, interest on de-

posits with banks or savings institutions is exempt from tax unless the interest is effectively connected with the conduct of a U.S. trade or business carried on by the recipient. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio debt obligations is exempt from the 30-percent tax. Certain U.S. income tax treaties also provide for exemption from tax in certain cases.[8]

U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real estate.

The source of income received by nonresident alien individuals and foreign corporations is determined under rules contained in the Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S. source income. Interest paid by the U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, interest paid by that person will be foreign source rather than U.S. source. Moreover, even though dividends paid by a corporation meeting this test (an "80/20" company) are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period is not subject to U.S. withholding tax. Conversely, dividends and interest paid by a foreign corporation are generally treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend will be considered U.S. source income. The U.S. source portion of such dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient of a dividend to the extent of such U.S. source portion unless a treaty prevents application of the branch profits tax on the payor of the dividend.)

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the country in which the

[8] Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that its net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited however, by the amount of tax-exempt interest paid to related persons and the amount of interest paid on debt guaranteed by tax-exempt related persons.

income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions of the Code contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis (as opposed to a "per-country" basis). Pursuant to rules enacted as part of the Tax Reform Act of 1986 (the "1986 Act"), the overall limitation is computed separately for certain classifications of income (i.e., passive income, high withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the crediting of foreign taxes on certain types of traditionally high-taxed foreign source income against the residual U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

Prior to the Tax Reform Act of 1984 (the "1984 Act"), a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided lookthrough rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act provided that foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction).

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if each country considers the same deduction allocable to income that it treats as foreign source income, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in situations were a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation--situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation generally is accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each

of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base in that jurisdiction. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent withholding tax and agrees to reduce this tax (or in the case of some income, eliminate it entirely) in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. Such a treaty provision generally is referred to as a so-called "saving clause." Double taxation also may arise, notwithstanding the existence of a treaty, because most countries will not exempt passive income from tax at the source.

Double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income is exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further enhanced under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individ-

ual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, the treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against enterprises owned by residents of the other country.

IV. EXPLANATION OF PROPOSED TAX TREATY

A detailed article-by-article explanation of the proposed income tax treaty between the United States and Russia is presented below. This explanation includes a discussion of the proposed protocol under the treaty articles amended by it.

Article 1. General Scope

The general scope article describes the persons who may claim the benefits of the proposed treaty and contains other rules regarding the general scope of the treaty, including the "saving clause."

The proposed treaty generally applies to residents of the United States and to residents of Russia, and to other persons as specified in other articles (e.g., Articles 23 (Non-discrimination) and 25 (Exchange of Information)) and discussed below. This follows other U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty. Residence is defined in Article 4.

The proposed treaty provides that it does not restrict any benefits accorded by internal law or by any other agreement between the United States and Russia. Thus, the treaty will apply only where it benefits taxpayers.

Like all U.S. income tax treaties, the proposed treaty is subject to a "saving clause." Under this clause, with specific exceptions described below, the treaty is not to affect the taxation by the United States of its residents, citizens, or former citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Russia as if the treaty were not in force. "Residents" for purposes of the treaty (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals who are not treated as residents of the other country under the treaty tie-breaker provisions governing dual residents (paragraphs 2 and 3 of Article 4 (Residence)).

Under Code section 877 ("Expatriation to avoid tax"), a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The treaty language described above regarding former citizens corresponds to provisions found in the U.S. model and most recent treaties specifically retaining the right to tax former citizens. Even absent a specific provision the Internal Revenue Service has taken the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).

Exceptions to the saving clause are provided for certain benefits conferred by the treaty, namely: correlative adjustments to the income of persons associated with other persons the profits of which were adjusted by the other country (Article 7, paragraph 2); exemp-

tion from residence country tax (or in the case of the United States, citizenship country tax) on social security benefits and other public pensions paid by the other country (Article 17, paragraph (b)); relief from double taxation (Article 22); nondiscrimination (Article 23); and mutual agreement procedures (Article 24).

In addition, the saving clause does not apply to the following benefits conferred by Russia with respect to individuals who are not Russian citizens, or the following benefits conferred by the United States with respect to individuals who possess neither U.S. citizenship nor immigrant status in the United States: exemption from tax on compensation from government service to the other country (Article 16)); exemption from tax on certain payments for the purposes of educating and supporting students, trainees, and researchers (Article 18); and certain fiscal privileges of diplomats referred to in the treaty (Article 26). For U.S. purposes, an individual has "immigrant status" in the United States if he has been admitted to the United States as a permanent resident under U.S. immigration laws (i.e., he holds a "green card").

The exceptions to the saving clause in the proposed treaty generally are consistent with the U.S. model and recent U.S. treaties. By contrast, the saving clause in Article VII of the USSR treaty states simply that it shall not restrict the right of a treaty country to tax its own citizens.

Article 2. Taxes Covered

The proposed treaty generally applies to the income and capital taxes of the United States and Russia. In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Internal Revenue Code, but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes. In addition, the proposed treaty applies to the excise taxes imposed with respect to the investment income of private foundations. In the case of Russia, the proposed treaty applies to the taxes on profits and income provided by the laws "On Taxes on Profits from Enterprises and Organizations," "On Taxation of Income of Banks," "On Taxation of Income from Insurance Activities," and "On the Income Tax on Individuals." The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes that either country may subsequently impose. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws. This clause is similar, but not identical, to U.S. model treaty language.

Finally, the proposed treaty applies to any tax on capital (that is, movable or real property, including but not limited to cash, stock or other evidences of ownership rights, notes, bonds or other evidences of indebtedness, and patents, trademarks, copyrights or other like right or property) imposed by either country under federal legislation, whether currently or in the future. The United States does not presently impose such a tax at the federal level; it is understood that Russia presently does.

For purposes of the nondiscrimination article (Article 23), the treaty applies to taxes of every kind and description. The proposed

treaty omits the U.S. model treaty language and the USSR treaty language specifying that these include any taxes imposed by political subdivisions or local authorities. It is understood that the negotiators did intend for such taxes to be covered for that purpose, however. For purposes of the exchange of information article (Article 25), the proposed treaty applies to taxes of every kind imposed by a treaty country.

Article 3. General Definitions

Certain of the standard definitions found in most U.S. income tax treaties are contained in the proposed treaty.

The term "Contracting State" means the United States or Russia, as the context requires.

The term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. Under Code section 638, where the term is used in a geographical sense, it includes the continental shelf; that is, the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. The proposed treaty provides that the term "United States," when used in a geographical sense, includes the territorial sea, and also the economic zone and continental shelf in which the United States, for certain purposes, may exercise sovereign rights and jurisdiction in accordance with international law and in which the tax legislation of the United States is in force. This treaty language thus makes explicit that the area described in Code section 638 generally is included in the term United States for treaty purposes.

The term "Russia" means the Russian Federation. When used in a geographical sense, those terms include the territorial sea, and also the economic zone and continental shelf in which the Russian Federation, for certain purposes, may exercise sovereign rights and jurisdiction in accordance with international law and in which the tax legislation of the Russian Federation is in force.

The term "person" means an individual, an estate, a trust, a partnership, a company, and any other body of persons. A "company" is any entity which is treated as a body corporate for tax purposes. In the case of Russia this means a joint stock company, a limited liability company or any other legal entity or other organization which is liable to a tax on profits.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft except when the transport is solely between places in one of the treaty countries. Accordingly, purely domestic transport in the United States, for example, is excluded.

The proposed treaty defines "capital" as movable or real property, including but not limited to cash, stock or other evidences of ownership rights, notes, bonds or other evidences of indebtedness, and patents, trademarks, copyrights or other like right or property.

The U.S. competent authority is the Secretary of the Treasury or his authorized representative. In fact, the U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commis-

sioner (International). On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

The Russian competent authority is the Ministry of Finance of the Russian Federation or its authorized representative.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms not defined in the treaty are to have the meaning which they have under the laws of the country applying the treaty.

Unlike most other U.S. treaties and the U.S. and OECD model treaties, the proposed treaty generally does not use the term "enterprise,"[9] and therefore contains no definition of that term or related terms. In places where other treaties typically refer to "an enterprise," (e.g., in defining a permanent establishment, and setting forth the treatment of business profits, related persons, shipping), the proposed treaty typically refers instead to "a person" or "a resident."

Article 4. Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence in a case where, under the internal laws of the countries, a person is taxed as a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on his U.S. source income and on his income that is effectively connected with a U.S. trade or business. An individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident (Code sec. 7701(b)). A permanent resident for immigration purposes (i.e., a green card holder) also is a U.S. resident. The standards for determining residence provided in the Code do not alone determine the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States.) A company is domestic, and therefore taxable by the United States on its worldwide income, if it is created or organized in the United States or under the laws of the United States, a State, or the District of Columbia.

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that country, is liable to tax therein by reason of his domicile, residence, citizenship, place of incorporation, or any other criterion of a similar nature. However, the term "resident of a Contracting State" does not include any person who is liable to tax in that country in respect only of income from sources in, or capital situated within, that country. In the case of income derived by a partnership, estate, or trust, residence is determined in accordance with the residence of the person liable to tax with respect to that income. For example,

[9] But see paragraph 3 of Article 10 (Dividends).

if the share of U.S. beneficiaries in the income of a U.S. trust is only one-half, Russia would have to reduce its withholding tax on only one-half of the Russian source income paid to the trust. According to the Treasury Department's Technical Explanation of the proposed treaty, it is understood that for purposes of the treaty, the government of a treaty country, or of one of its political subdivisions, is to be considered to be a resident of that country.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. and OECD model treaties and is similar to the provisions found in other U.S. tax treaties. However, a significant difference between the definition of resident in this treaty and the definition in other recent U.S. income tax treaties, and consequently a significant difference in the coverage of the treaty, is that a U.S. citizen is considered a U.S. resident for purposes of the treaty. As a result, U.S. citizens residing overseas (in countries other than Russia) are entitled to the benefits of the treaty as U.S. residents. This result reflects U.S. treaty policy as expressed in the U.S. model, but is achieved in very few treaties.

A set of "tie-breaker" rules is provided to determine residence in the case of an individual who, under the basic residence rules, would be considered to be a resident of both countries. Such a dual resident individual will be deemed to be a resident of the country in which he has a permanent home available to him. If this permanent home test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, i.e., his "center of vital interests." If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he shall be deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he shall be deemed to be a resident of the country of which he is a citizen. If each country considers him to be its citizen or he is a citizen of neither of them, the competent authorities of the countries are to settle the question of residence by mutual agreement.

In the case of a company that is a resident of both countries under the basic treaty definition, the treaty requires the competent authorities of the two countries to endeavor to settle the question by mutual agreement. If they are unable to make such a determination, the person will be considered a resident of neither treaty country for purposes of receiving any treaty benefits. (Such a dual resident may be treated as a treaty country resident for other purposes, however, such as entitling a person receiving a dividend from a dual resident (in the case of a dual resident corporation) to reduced source country taxation on the dividend.) In this the proposed treaty is similar to some other existing treaties, but dissimilar to the U.S. model treaty which does not specify absence of treaty benefits in cases where the competent authorities cannot agree.

In the case of a person other than a company or an individual that is a resident of both countries under the basic treaty definition, the proposed treaty, like the U.S. model treaty, requires the competent authorities of the two countries to settle the question by

mutual agreement and determine the mode of application of the treaty to the person.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that, subject to certain modifications, generally follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, U.S. treaties provide that an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties will apply, or whether those amounts will be taxed as business profits. Taxation of business profits is discussed under Article 6 (Business Profits).

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which a resident of one of the treaty countries engages in business in the other treaty country. For this purpose no distinction is made between residents that are or are not legal entities. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. A building site or construction, assembly, or installation project, or an installation or drilling rig or ship used to explore for or exploit natural resources, may also constitute a permanent establishment, but only if it lasts for more than 18 months. The 18-month period for establishing a permanent establishment in connection with a site or project is longer than the 12-month period set forth in the U.S. model treaty. Under the USSR treaty, the source country is prohibited from taxing the income of a resident of the other country from furnishing engineering, architectural, designing, and other technical services in connection with an installation contract with a resident of the source country and which are carried out in a period not longer than 36 months at one location. Thus, relative to the USSR treaty, the proposed treaty represents a move in the direction of the U.S. model, and it allows host country taxation under some circumstances where it is now forbidden.

The general rule is modified to provide that use or maintenance of a fixed place of business solely for any of a number of specified activities will not be treated as the carrying on of an activity through a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the person and the maintenance of a stock of goods belonging to the person solely for storage, display, or delivery, or solely for processing by another person. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the person, or solely for the purpose of carrying on, for the

person, any other activity of a preparatory or auxiliary character. The foregoing activities are specified in the U.S. model as well. The proposed treaty adds to the list the maintenance of a fixed place of business by the person solely for the purposes of facilitating the conclusion of, or for the mere signing of, contracts in the name of the person concerning loans or the delivery of goods or merchandise or technical services.

As under the U.S. model treaty, the proposed treaty provides that a fixed place of business used solely for any combination of the listed activities will not constitute a permanent establishment.

If a treaty country resident carries on activities in the other country through an agent, then the principal may be deemed to have a permanent establishment in the other country by virtue of the activities that the agent undertakes for the principal. Consistent with the model treaties, the principal is not deemed to have a permanent establishment under this rule unless a number of conditions are satisfied. First, the agent must have, and habitually exercise, the authority to conclude contracts in the other country in the name of the principal. Second, the agent must not be a broker, general commission agent, or any other agent of independent status acting in the ordinary course of its business through which the principal carries on business in the other country. Third, the agent's activities must not be limited to those (described above) such as storage, display, or delivery of merchandise which are excluded from the definition of permanent establishment.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. Such relationships are thus not relevant; only the activities of the person being tested (and its agents) are relevant.

Article 6. Business Profits

U.S. Code rules

U.S. law distinguishes between the U.S. business income and the other U.S. income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as U.S. business income or not varies depending upon whether the source of the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in

a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (thus it is said to be taxed as if it were business income under a limited "force of attraction" rule).

In the case of foreign persons other than insurance companies, foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. For such persons, only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office.

The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code may be treated as U.S.-effectively connected without regard to the foregoing rules, so long as that income is attributable to its U.S. business. In addition, the net investment income of such a company which must be treated as effectively connected with the conduct of an insurance business within the United States is not less than an amount based on a combination of asset/liability ratios and rates of return on investments experienced by the foreign person in its worldwide operations and by the U.S. insurance industry.

Except in the case of a dealer, trading in stocks, securities, or commodities in the United States for one's own account generally does not constitute a trade or business in the United States, and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S.-based employee, a resident broker, commission agent, custodian or other agent, or trading by a foreign person physically present in the United States.

The Code as amended by the Tax Reform Act of 1986 provides that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition, the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Proposed treaty rules

Under the proposed treaty, business profits of a resident of one country are taxable in the other country only to the extent that they are attributable to the assets or activity of a permanent establishment in the other country through which the person carries on,

or has carried on, business. As elaborated upon in the proposed protocol, profits are attributable to a permanent establishment only if the profits are derived from the assets employed by, or the activities engaged in by, the permanent establishment. Profits derived from other assets or activities are not attributable to the permanent establishment. Income from any particular investment or activity, regardless of source, must be separately tested to determine whether it may be treated as profit attributable to a permanent establishment in a treaty country; the determination whether profits from an investment are attributable to the permanent establishment is based on the actual information about the investment. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The proposed treaty differs from the model treaties in permitting a country to tax profits if the other-country resident carries "or carried" on business in that country. Addition of the words "or carried" clarifies that, for purposes of the treaty rules stated above, any income, gain or expense attributable to a permanent establishment during its existence is taxable or deductible in the country where the permanent establishment is situated even if the payments are deferred until after the permanent establishment has ceased to exist.

The proposed protocol provides two illustrations of these concepts. The first example involves a person resident in one of the treaty countries engaged in a construction project for 4 years at a site in the other country. Given the duration of the site, the person has a permanent establishment in the second country and its profits from its construction activities are taxable in the second country. The example posits a simultaneous sale by the person of equipment for another project owned by the same customer. The signing (but not the negotiation) of the contract of sale takes place in the second country, and under Article 5 of the treaty, the signing does not constitute a permanent establishment. The proposed protocol provides that in this case the profits from the equipment sales are not liable to tax in the second country.

The second example involves a company resident in one of the treaty countries that engages in oil and gas exploration, development, and production worldwide. The company produces oil and gas at a well in the other treaty country, which is a permanent establishment under the treaty. The company also explores for oil in the second country for less than 18 months, but not at the site of the producing well, and not using employees of, or assets from, the well site. In addition, the company occasionally rents idle drilling equipment otherwise used in exploration to third persons for use in the second country. The proposed protocol states that in this case, the exploration and rental activities do not constitute a permanent establishment, the exploration expenses are not deductible in determining the production income taxable in the second country, and the rental income is not taxable in the second country.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard.

Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Profits from U.S. source income other than U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains, are treated as effectively connected with the conduct of a trade or business in the United States, and taxed as such by the United States, without regard to whether they were derived from business activities or business assets. Under the proposed treaty, by contrast, some level of fixed place of business must be present and the business profits must be attributable to assets or activities of that fixed place of business.

Russian law or practice has authorized the use of various methods of computing the income of the Russian permanent establishment of a foreign person, including in certain circumstances either the application of a formulary apportionment of profit based on sales, expenses, or payroll, or an assumed 25 percent rate of profit on revenues or expenses. Under the proposed treaty, there are to be attributed to a permanent establishment the business profits which would be expected to have been derived by it if it were a distinct and independent person engaged in the same or similar activities under the same or similar conditions. Amounts may be attributed to the permanent establishment whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits attributable to the permanent establishment, deductions are allowed for expenses, wherever incurred, which are incurred for the purposes of the permanent establishment. As specified in the proposed protocol, properly substantiated payments to third parties, by units of the person of which the permanent establishment is a part (e.g., the head office or offices in third countries) should be taken into account to the extent the payments relate to the assets or activities of the permanent establishment, or to the extent that the payments relate to the assets or activities of the person as a whole and are reasonably allocable to the permanent establishment. It is unnecessary for these payments to be reimbursed by the permanent establishment to the office making the payments.

These deductions include a reasonable allocation of properly documented expenses including executive and general administrative expenses, research and development expenses, interest, and charges for management, consultancy, or technical assistance. In the case of interest, Russia agrees under the proposed protocol that a Russian permanent establishment of a U.S. resident may deduct interest, whether paid to a bank or another person, and without regard to the period of the loan. As discussed below in connection with the proposed treaty's provision on relief from double taxation (Article 22), interest deductions for purposes of computing Russian (and Soviet) income or profits tax have been subject to various limitations, including limitations based on the term of a loan, the rate of interest, and whether or not the interest was paid to a bank. The language in the protocol thus appears to be intended generally to prevent limitations such as these, or others of a similar nature, from being applied in computing the business profits attributable to a permanent establishment. However, the deduction may not ex-

ceed the limitation under Russian tax law, as long as the limitation is not less than the London Inter-bank Offered Rate ("LIBOR") plus a reasonable risk premium to be provided for in the loan agreement. (See the discussion of the corresponding rules under Article 22)

Under this language, which differs in some respects from the U.S. model, the staff understands that the United States is currently free to use its expense allocation rules in determining the reasonable amount. Thus, for example, a Russian company which has a branch office in the United States but which has its head office in Russia will, in computing the U.S. tax liability of the branch, be entitled to deduct a portion of the executive and general administrative expenses incurred in Russia by the head office, allocated and apportioned in accordance with Treas. Reg. sec. 1.861-8, for purposes of operating the U.S. branch.

The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method. The proposed protocol states the understanding of the parties that the documentation of expenses claimed as deductions by a permanent establishment need not be submitted with the tax return but must be made available by the taxpayer on the request of the tax authorities.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the person of which it is a part. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities.

For purposes of the article 6 of the proposed treaty, the term "business profits" includes, for example, profits from manufacturing, mercantile, agricultural, forestry, fishing, transportation, communication, or extractive activities, from the rental of tangible movable property, and from the furnishing of services to another person. Unlike the U.S. model and some existing U.S. treaties, the proposed treaty does not specify that business profits include income from the rental or licensing of cinematographic films or works on film, tape, or other means of reproduction for use in radio or television broadcasting. Such income generally is defined as "royalties" under Article 12. It is nevertheless taxable to the extent permitted in Article 6 if it is attributable to a permanent establishment (Article 12(3)).

The term "business profits" does not include income received by an individual for his performance of personal services, either as an employee or in an independent capacity. Such income is dealt with in the articles on income from employment (Article 14) and independent personal services (Article 13).

Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles are not affected by the business profits article. Thus, those other articles, and not the business profits article, generally will govern the treatment of those items of income. For example, dividends are taxed under the provisions of Article 10 (Dividends), and not as business profits, except as provided in paragraph 4 of Article 10.

Article 7. Adjustments to Income in Cases Where Persons Participate, Directly or Indirectly, in the Management, Control or Capital of Other Persons

The proposed treaty, like most other U.S. tax treaties, contains an arm's length pricing provision, similar to section 482 of the Code, which recognizes the right of each country to adjust the taxable incomes of treaty country residents and related persons where necessary to reflect the conditions on which their commercial or financial relationships would have been based had they been independent persons.

For purposes of the proposed treaty, a resident of one treaty country is related to a resident of the other country if one of these persons participates directly or indirectly in the management, control, or capital of the other. A resident of one treaty country is also related to another person if the same persons participate directly or indirectly in their management, control, or capital.

The proposed treaty states that this provision is not intended to limit either country in applying its domestic law to make adjustments to income, deductions, credits, or allowances between persons when necessary in order to prevent the evasion of taxes or clearly to reflect the income of those persons. Thus, the proposed treaty makes clear that the United States retains the right to apply its intercompany pricing rules (Code section 482 and the regulations thereunder, including, it is understood by Treasury, the "commensurate with income" standard for pricing transfers of intangibles) and its rules relating to the allocation of deductions (Code sections 861, 862, 863, and 864, and applicable regulations).

When a redetermination of tax liability has been made by one country in accordance with the treaty, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making that adjustment, due regard is to be given to other provisions of the treaty, and the competent authorities of the two countries will consult with each other as necessary. For example, under the mutual agreement article (Article 24), a correlative adjustment cannot necessarily be denied on the ground that the time period set by internal law for claiming a refund has expired. To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship will not apply in the case of such adjustments.

Article 8. International Transport

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax generally is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

Under the proposed treaty, income of a resident of one country from the operation in international traffic of ships or aircraft will be exempt from tax by the other country, regardless of the existence of a permanent establishment in the other country. Inter-

national traffic means any transport by ship or aircraft, except where the transport is solely between places in one of the countries (Article 3(1)(g) (General Definitions)). Unlike the exemption provided in the USSR treaty, the exemption in the proposed treaty applies whether or not the ships or aircraft are registered in the first country. Thus, for example, Russia would not tax the income of a U.S. resident operating a Liberian-flag vessel in international traffic.

As provided under the U.S. model, the proposed treaty provides similar protection from source country taxation of income from rental of ships or aircraft operated in international traffic by the lessee, and from rental of ships and aircraft, whether or not operated in international traffic, if the rental activity is incidental to the operation of ships or aircraft in international traffic by the lessor. For example, the proposed treaty provides for exemption from tax in the source country for a bareboat lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic but that leases ships or aircraft for use in international traffic.

The exemption also applies to income (including demurrage) from the use or rental of containers used in international traffic, and trailers, barges, and other related equipment for the transport of containers. (The U.S. model provides similar treatment for income derived from the maintenance of containers, trailers, barges, and related equipment. The staff understands that the substitution of the term "demurrage" for the term "maintenance" in the proposed treaty is not intended to provide a result different from the U.S. model.) In addition, the shipping and air transport provisions apply to income from participation in a pool, joint business, or international transportation agency, assuming that the other provisions of the treaty (e.g., the limitation on benefits article (Article 20) or paragraph 1 of Article 4 (Residence), relating to treaty benefits for income of partnerships, trusts, and estates) permit such application.

Article 9. Income from Real Property

This article covers income from real property. The rules covering gains from the sale of real property and real property interests are in Article 19 (Other Income).

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be taxed in the country where the real property is located. Income from real property includes income from agriculture or forestry.

The term "real property" includes any interest owned or held in tenancy by any individual or entity in land, unsevered products of land, and any fixture built on that land, as well as other property considered real property under the law of the country in which the property is situated. Ships, boats, and aircraft are not real property.

The source country may tax income derived from the direct use, letting, or use in any other form of real property. As described above in connection with Article 6 (Business Profits), in the case of income from real property that is also business profits (for exam-

ple, income from agricultural or forestry activities), Article 9 is not affected by the provisions of the business profits article (Article 6).

The proposed treaty, like the U.S. model treaty and certain other U.S. income tax treaties, provides residents of one country with an election to be taxed on a net basis by the other country on income from real property in that other country. The treaty permits the taxpayer to elect, subject to the procedures of the domestic law of the source country, to compute the tax on a net basis as if the income were attributable to a permanent establishment in the source country. The election is binding for the taxable year of the election and all subsequent taxable years unless revoked pursuant to the procedures under the domestic law of the source country. A net basis election is provided for U.S. real property income under the Code (secs. 871(d) and 882(d)).

Article 10. Dividends

In general

The USSR treaty generally imposes no restriction on the source-country taxation of dividends. The proposed treaty limits the source country tax rate generally on direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting shares of the payor) to 5 percent, and limits the source country tax rate on other dividends to 10 percent. The proposed treaty permits exceptions to the foregoing source country rates, however, on dividends from a regulated investment company (RIC) or a real estate investment trust (REIT). The proposed treaty also permits taxation under the dividend rules of income from arrangements, including debt obligations, carrying the right to participate in profits but deductible by the payor. Finally, the proposed treaty limits to 5 percent the rate of the branch profits tax, and restricts its base as in other treaties.

Internal dividend and branch profits taxation rules

The United States generally imposes a 30-percent tax on the gross amount of U.S. source dividends (other than dividends paid by an "80/20 company" described in Code section 861(c)) paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates, on a net basis.

In addition, a foreign corporation engaged in the conduct of a trade or business in the United States is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business.

U.S. source dividends are generally dividends paid by a U.S. corporation. Also treated as U.S. source dividends for this purpose are portions of certain dividends paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the

conduct of a U.S. trade or business. The U.S. source portion of such dividend is generally equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to its total gross income. No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax. The tax imposed on the latter dividends is often referred to as the "second-level" withholding tax.

In general, corporations do not receive deductions for dividends paid under U.S. law. Thus, the withholding and branch taxes often represent imposition of a second level of tax on corporate taxable income. Treaty reductions of these taxes reflect the view that where, for example, the United States already imposes corporate level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source country taxation. Moreover, the 5-percent rate reflects the view that the source country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A REIT is a corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met (Code sec. 857(b)). One of those conditions is the requirement that a REIT distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. Often, the principal income of a REIT is rentals from real estate holdings.

Because a REIT is taxable as a U.S. corporation, a distribution of earnings is treated as a dividend, rather than income of the same type as the underlying earnings. This is true even though the REIT generally is not taxable at the entity level on the earnings it distributes. Because a REIT cannot be engaged in an active trade or business, its distributions are U.S. source and are thus subject to U.S. withholding tax of 30 percent when paid to foreign owners. Distributions of rental income, for example, are not themselves considered rental income. Like dividends, U.S. source real property rental income of foreign persons is generally subject to U.S. withholding tax at a statutory rate of 30 percent (unless, in the case of rental income, the recipient elects to have it taxed in the United States on a net basis at the regular income tax rates). Unlike the tax on dividends, however, the withholding tax on rental income is generally not reduced in U.S. income tax treaties.

The Code also generally treats RICs as both corporations and conduits for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus, the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

Russia has imposed by internal law a 15-percent withholding tax on Russian source dividends paid to foreign legal persons lacking a Russian permanent establishment, and a 20-percent tax in the case of nonresident individual recipients. For this purpose, divi-

dends have included income transmitted abroad to the foreign participants of an enterprise with foreign investments—often, a joint venture—created under the laws of the Russian Federation.

Treaty reduction of dividend taxes

Under the proposed treaty, each country may tax dividends paid by its resident companies, but the rate of tax is limited by the treaty if the beneficial owner of the dividends is a resident of the other country. Source country taxation is generally limited to 5 percent of the gross amount of the dividends if the beneficial owner of the dividends is a company that holds directly at least 10 percent of the voting shares of the payor corporation. If the payor is a resident of Russia and there is no voting stock, the 5-percent rate applies if the beneficial owner is a company resident in the United States that owns at least 10 percent of the statutory capital of the payor. The tax is generally limited to 10 percent of the gross amount of the dividends in other cases involving dividends beneficially owned by residents of the other country. The U.S. and OECD models and other U.S. treaties (with the exception of the U.S.-China and U.S.-Romania treaties) generally permit the United States to impose a tax of at least 15 percent on these so-called "portfolio" dividends. In the U.S. treaties with France, Germany, and the United Kingdom, on the other hand, those countries are required to provide integration-related benefits to U.S. portfolio shareholders in domestic companies; the treaty benefits to such shareholders are thus greater than those under a regime in which the only treaty benefit is a 15-percent ceiling on the withholding tax.

As provided in the proposed protocol, the prohibition on source country tax in excess of 5 percent on direct investment dividends does not apply to a dividend from a RIC. Thus, the proposed treaty allows the United States to impose a 10-percent tax on a U.S. source dividend paid by a RIC to a Russian company owning 10 percent or more of the voting shares of the RIC. In addition, there is no limitation in the proposed treaty on the tax that may be imposed by the United States on a dividend paid by a REIT to a Russian resident. Such a dividend would thus be taxable by the United States, assuming no change in present internal law, at the full 30-percent rate.

The limitations on source country taxation of dividends do not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Definition of dividends

The proposed treaty provides a definition of dividends that is similar to the definition in the U.S. model treaty and some U.S. treaties. Like the U.S. model treaty, the proposed treaty generally defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. Dividends also include income from other rights that is subjected to the same tax treatment as income from shares by the country in which the distributing corporation is resident. The proposed treaty also provides (unlike the U.S. model treaty) that the term dividends includes income from arrangements, *including debt obligations,* carrying the

right to participate in profits, to the extent so characterized under the law of the source country. Thus, the treaty would permit dividend treatment of an "equity kicker" amount that is paid on a loan. In the case of Russia, the term "dividend" includes income transmitted abroad to the foreign participants of an enterprise with foreign investments created under the laws of the Russian Federation.

Special rules and exceptions

The proposed treaty's reduced rates of tax on dividends will not apply if the dividend recipient has or had a permanent establishment (or fixed base in the case of an individual who performs or performed independent personal services) in the source country and the dividends are attributable to the permanent establishment (or fixed base). Dividends so attributable to a permanent establishment are to be taxed as business profits (Article 6). Dividends attributable to a fixed base are to be taxed as income from the performance of independent personal services (Article 13).

Branch profits tax

The proposed treaty would expressly permit the United States to collect the branch profits tax—that is, a tax on a "dividend equivalent amount" in addition to the tax on profits—from a Russian company, and would permit Russia to collect a similar tax from a U.S. company. The proposed treaty forbids the United States to impose on a Russian company the branch level interest tax that applies to the excess of a branch's interest deductions over its interest payments. This is consistent with the treaty's elimination of source country tax on interest, as described below in connection with the interest article (article 11).

The Code as amended by the 1986 Act imposes branch level taxes on foreign corporations earning income effectively connected with the conduct of a U.S. trade or business. The Code provides that no U.S. treaty shall exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country.

The Code defines a "qualified resident" as any foreign corporation which is a resident of a treaty country if can meet at least one of the following tests. First, any foreign corporation resident in a treaty country is a qualified resident of that country unless 50 percent or more (by value) of the stock of the corporation is owned (directly or indirectly within the meaning of Code section 883(c)(4)) by individuals who are not residents of the treaty country and who are not U.S. citizens or resident aliens, or 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of the treaty country or citizens or residents of the United States. Second, a foreign corporation resident in a treaty country is a qualified resident if the stock of the corporation is primarily and regularly traded on an established securities market in the treaty country, or if the corporation is wholly owned (either directly or indirectly) by another foreign corporation which is organized in the treaty country and the stock of which is so traded, or is wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States.

The proposed treaty, like the USSR treaty, would allow the United States to impose the branch profits tax (as opposed to the branch level excess interest tax (Code sec. 884(f)) on a Russian corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on income from real property or gains from the disposition of real property interests.[10] However, the proposed treaty permits at most a 5-percent branch tax rate, and, in cases where a corporation resident in one treaty country conducts a trade or business in the other country, but not through a permanent establishment, the proposed treaty would prohibit imposition of the branch profits tax (other than in connection with real property income or gains).

The tax may be imposed by the source country only to the extent of that portion of profits taxable by the source country as business profits of the corporation attributable to its permanent establishment in the source country, or real property income and gains in the source country, and then only to the extent that this portion represents the "dividend equivalent amount" of those profits. The proposed protocol describes the dividend equivalent amount generally as the portion of profits comparable to the amount that would be distributed as a dividend if such income were earned by a locally incorporated subsidiary. In the case of the United States, the term has the meaning that it has under U.S. law as it may be amended from time to time without changing the foregoing general principle. (Under current U.S. internal law as applied to a permanent establishment, the dividend equivalent amount of business profits attributable to a permanent establishment generally is the earnings and profits attributable to a U.S. permanent establishment, plus an additional amount representing any decreases in the permanent establishment's "U.S. net equity" and minus an amount representing any increase in the permanent establishment's U.S. net equity. The staff understands that a 5 percent U.S. tax on this amount is allowed under the proposed treaty and proposed protocol. None of the restrictions on the operation of U.S. or Russian internal law branch tax provisions apply, however, unless the corporation seeking treaty protection meets the conditions of the proposed treaty's limitation on benefits article (Article 20). As described in the discussion of Article 20 below, the limitation on benefits requirements of the proposed treaty are very similar, but not identical, to the corresponding provisions of the branch profits tax provisions of the Code described above.

Article 11. Interest

Internal interest taxation rules

Subject to numerous exceptions (such as those for portfolio interest, bank deposit interest, and short term original issue discount), the United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. U.S. source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that meets the foreign business requirements

[10] A sentence in the non-discrimination article (Article 23) also provides that nothing in that article prevents a treaty country from imposing the branch profits tax as described above.

of Code section 861(c) (e.g., an 80/20 company). Also subject to the 30-percent tax is interest paid to a foreign person by the U.S. trade or business of a foreign corporation. A foreign corporation is also subject to a branch level excess interest tax, which is the tax it would have paid had a wholly owned domestic corporation paid it the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business (sec. 884(f)).

Portfolio interest generally is defined as any U.S. source interest that is not effectively connected with the conduct of a trade or business and (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution.[11]

Under a provision enacted in the Omnibus Budget Reconciliation Act of 1993, the portfolio interest exemption is inapplicable to certain contingent interest income. For this purpose, contingent interest generally includes interest determined by reference to any of the following attributes of the debtor or any related person: receipts, sales, or other cash flow; income or profits; or changes in the value of property. In addition, contingent interest generally includes interest determined by reference to any dividend, partnership distribution, or similar payment made by the debtor or a related person. A number of exceptions apply, including an exception for interest determined by reference to changes in the value of, or yields on, certain actively traded property. In the case of an instrument on which a foreign holder earns both contingent and non-contingent interest, denial of the portfolio interest exemption applies only to the portion of the interest which is contingent interest.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit (REMIC), the REMIC is treated generally for U.S. tax purposes as a pass-through entity and the investor is subject to U.S. tax on some portion of the REMIC's income (which in turn is generally interest income). If the investor holds a so-called "residual interest" in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor—referred to as the investor's "excess inclusion"—may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax under section 511, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor were otherwise eligible for such a rate reduction.

Russia has imposed by internal law a 15-percent withholding tax on Russian source interest paid to foreign legal persons lacking a Russian permanent establishment, and a 20-percent tax in the case of nonresident individual recipients.

---

[11] Certain additional exceptions to this general rule apply only in the case of a corporate recipient of interest. In such a case, the term portfolio interest generally excludes (1) interest received by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), and (2) interest received by a controlled foreign corporation from a related person.

Treaty reduction of interest taxes

The proposed treaty generally provides that interest derived and beneficially owned by a resident of a country may be taxed only by that country. The proposed protocol states that notwithstanding the general exemption, however, U.S. internal law may be applied to an excess inclusion with respect to a REMIC. Thus, the proposed treaty generally exempts from the U.S. 30-percent tax U.S. source interest paid to Russian residents, and exempts from Russian taxes interest paid to U.S. residents. The USSR treaty, by contrast, imposes a restriction on the source-country taxation of interest, but only in the case of interest in connection with the financing of trade between the United States and the Soviet Union.

The exemptions of the proposed treaty apply only if the interest is beneficially owned by a resident of one of the countries. Accordingly, they do not apply if the recipient of the interest is a nominee for a nonresident. In addition, the exemptions will not apply if the beneficial owner has or had a permanent establishment or fixed base in the source country and the interest is attributable to the permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article 6) or income from the performance of independent personal services (Article 13).

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by holding that the amount of interest for purposes of applying this article will be the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 10 of the proposed treaty.

Subject to an exception, the treaty defines interest as income from debt claims of every kind, unless described in the dividend article (which covers, for example, certain income from debt obligations carrying the right to participate in profits). In particular, interest includes income from government securities and from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures, as well as all other income that is treated as income from money lent by the tax law of the source country. The proposed treaty omits the sentence in the U.S. and OECD models stating that penalty charges for late payment also are not interest for purposes of the proposed treaty. The Technical Explanation states that such amounts are "Other income" for purposes of the treaty, and therefore exempt from tax at source, similarly to interest under Article 11.

Article 12. Royalties

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax U.S. source royalties paid to foreign persons, and on gains from the disposition of certain intangible property to the extent that gains are from payments contingent on the productivity, use, or disposition of intangible property. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include roy-

alties for the use of or the right to use intangible property in the United States. Such royalties include motion picture royalties. Russia has imposed by internal law a 20-percent withholding tax on similar amounts derived from Russian sources by foreign persons.

The proposed treaty provides that royalties derived and beneficially owned by a resident of a country generally may be taxed only by that country. Thus, the proposed treaty generally exempts from the U.S. 30-percent tax U.S. source royalties paid to Russian residents, and exempts from Russian tax royalties paid to U.S. residents. These reciprocal exemptions are similar to those provided in the U.S. and OECD model treaties.

The exemptions apply only if the royalty is beneficially owned by a resident of the other country; they do not apply if the recipient of the royalty is a nominee for a nonresident.

In addition, the exemptions will not apply if the beneficial owner has or had a permanent establishment or fixed base in the source country and the royalties are attributable to the permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article 6) or income from the performance of independent personal services (Article 13).

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties having an otherwise special relationship) by holding that the amount of royalties for purposes of applying this article will be the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length royalty, for whatever reason, will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid to a parent corporation may be treated as a dividend under local law and thus may be entitled to the benefits of Article 10 of the proposed treaty.

Royalties are defined to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including computer programs, video cassettes, and cinematographic films and tapes for radio or television broadcasting; for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience. In contrast to the U.S. model treaty, the term "royalties" does not include gains from the alienation of a right or property described above which are contingent on the productivity, use, or further alienation of such right or property. Thus, such gains are subject to the "Other income" article which, similar to the royalty article, generally provides for taxation only by the country of residence of the person earning the income.

Article 13. Independent Personal Services

Services income in general

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 6 (Business Profits).) The performance of personal services

within the United States can be a trade or business within the United States (Code sec. 864(b)).

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is excluded from U.S. source income, and therefore not taxed by the United States in the absence of a U.S. trade or business, if certain criteria are met. The criteria are: (1) the individual is not in the United States for over 90 days during a taxable year, (2) the compensation does not exceed $3,000, and (3) the services are performed as an employee of or under a contract with a foreign person not engaged in a trade or business in the United States, or they are performed for a foreign office or place of business of a U.S. person.

The U.S. and OECD model treaties and more recent U.S. treaties divide income from personal services into a number of categories, generally including in each case independent personal services, dependent personal services, income from government service, and from pensions, and in some cases also including one or more of the following categories: directors' fees, certain income of entertainers and athletes, income from teaching or research, and income of students and trainees.

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) is treated separately from income from the performance of dependent personal services.

Independent personal services

Income from the performance of independent personal services in one country by a resident of the other country will be exempt from tax in the country where the services are performed (the source country) unless the individual performing the services has or had a fixed base regularly available to him in that country for the purpose of performing the services, and the individual is or was present in the source country for periods exceeding in the aggregate 183 days in the calendar year. In that case, the source country can tax only that portion of the individual's income that is attributable to the fixed base, determined in accordance with principles similar to those set forth in the Business Profits article (article 6) for determining the amount of business profits and attributing business profits to a permanent establishment. The proposed treaty restricts source country taxation to a greater extent than the U.S. and OECD model treaties, and numerous U.S. treaties, by requiring presence in the source country for more than 183 days. Such a restriction applies to personal service income generally under the USSR treaty.

For purposes of this article, independent personal services include, in particular, independent scientific, literary, artistic, educational, or teaching activities, as well as the independent services of physicians, lawyers, engineers, architects, dentists, and accountants. Services performed as a partner in a partnership are included where the partner receives the income and bears the losses arising from the services.

It is understood that the proposed treaty language conforms the treatment of income derived from independent personal services with Code section 864(c)(6). Therefore, if a Russian resident receives income for independent activities rendered by that resident, and the activities were performed in the United States in a year during which the resident had a regularly available fixed base, then that income is taxable by the United States, regardless of whether payment for the activities was deferred to years in which the resident had no presence in the United States.

Implementation of source country limitations via refund of withheld taxes

As a matter of internal law, the United States generally implements treaty reductions in taxes subject to withholding by reducing the amounts of tax withheld at the source. An alternative that the United States views as permissible under treaties is the refund of amounts withheld at the statutory rates. The proposed protocol contains express language regarding the latter method under the proposed treaty. The protocol makes it clear that taxes withheld at the regular internal law rates will be refunded in a timely manner on application by the taxpayer, if the right to collect the tax is limited by the provisions of the treaty, including article 13.

Article 14. Income from Employment

Under the proposed treaty, wages, salaries, and other similar remuneration derived from services performed as an employee in one country (the source country) by a resident of the other country will be taxable only in the country of residence if three requirements are met: (1) the individual is present in the source country for fewer than 184 days during the calendar year concerned; (2) his employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country. This degree of limitation on source country taxation is consistent with the U.S. and OECD model treaties.

Also consistently with the U.S. and OECD model treaties, and the USSR treaty, the proposed treaty provides that compensation derived from employment as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only in the employee's country of residence.

The USSR treaty exempts from source country tax the remuneration from abroad of a resident of the other country temporarily present, up to one year, to perform technical services as an employee of, or under contract with, a resident of the other country. The proposed treaty, in addition to the restrictions on source country taxation described above, adds two more restrictions not found in the model treaties, but related to this USSR treaty restriction.

The first restriction prohibits source country taxation if the employment is directly connected with a place of business which is not a permanent establishment, and the employee is present in the source country for a period not exceeding 12 consecutive months. The proposed protocol states the parties' understanding that temporary absences of less than one month will be disregarded for purposes of measuring the 12 consecutive-month period. The proposed

protocol also states the parties' understanding that an individual described in this provision may be employed at more than one such place of business.

The second restriction on source country taxation referred to above prohibits source country taxation of employment income from providing technical services that are directly connected with the application of a right or property giving rise to a royalty, if the services are provided as part of a contract granting the use of the right or property.

This article is modified in some respects for directors' fees (Article 15), government service (Article 16), and pensions (Article 17).

Article 15. Directors' Fees

Under the proposed treaty, directors' fees and similar payments derived by a resident of one country for services as a member of the board of directors of a company which is a resident of the other country may be taxed in that other country.

This treaty rule follows the OECD model treaty, in effect placing no limits on the ability of the country of residence of the company to tax the fees of that company's directors. The commentary to the OECD model indicates that the U.S. representatives to the OECD Committee on Fiscal Affairs have indicated that the United States would in its negotiations require that any tax imposed on directors' fees be limited to income earned from services performed in the source country. Moreover, the U.S. model generally treats directors' fees as personal service income.

Article 16. Government Service

The proposed treaty contains a provision, similar to the OECD model treaty, that generally exempts the wages of employees of one of the countries from tax by the other country. Under the proposed treaty, non-pension remuneration for services rendered in the discharge of functions of a governmental nature, paid from the public funds of the United States or one of its political subdivisions, by Russia or one of its republics, or by a local authority of either country, will generally be taxable only in the country of the employer. However, such remuneration will be taxable only in the other country if the services are rendered in that other country and the individual is a resident of that other country who either (1) is a citizen of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, Russia would not tax the compensation of a U.S. citizen and resident who goes to Russia in order to perform services for the U.S. Government, and the United States would not tax the compensation of a Russian citizen and resident who performs services in Russia for the U.S. Government.

Any pension paid from the public funds of a country, or a subdivision, authority, or republic as described above, to an individual for services rendered to that government will generally be taxable only in the country of the employer. However, such pensions will be taxable only in the other country if the individual is both a resident and a citizen of that other country.

In the situations described above, the U.S. model treaty allows exclusive taxing jurisdiction to the paying country, but only in the case of payments to one of its citizens.

As under the USSR treaty and the model treaties, if a country or one of its political subdivisions, republics, or local authorities is carrying on a business (as opposed to functions of a governmental nature), the provisions of Articles 13 (Independent Personal Services), 14 (Income from Employment), and 17 (Pensions) will apply to remuneration and pensions for services rendered in connection with the business.

Article 17. Pensions

Under the proposed treaty, pensions and other similar remuneration derived and beneficially owned by a resident of either country in consideration of past employment are subject to tax only in the recipient's country of residence. This rule is subject to the provisions of Article 16 (Government Service). Thus, it does not apply, for example, in the case of pensions paid to a resident of one country attributable to services performed for government entities of the other unless the resident of the first country is also a citizen of the first country.

Social security benefits and other public pensions will be taxable only in the paying country. This rule, which is not subject to the saving clause, exempts U.S. citizens and residents from U.S. tax on Russian social security payments. Under this rule, only the United States may tax U.S. social security payments to U.S. persons residing in Russia. The rule thus safeguards the United States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by nonresident individuals, while protecting any such individuals residing in Russia from double taxation.

Article 18. Students, Trainees and Researchers

An individual resident of one treaty country may visit the other country temporarily in order to study, train, or do research. In such a case the proposed treaty, like the USSR treaty, prohibits the second, or host, country from taxing the visitor in certain cases. This provision limits host-country taxation to a lesser extent than the corresponding provisions of the USSR treaty; on the other hand, it imposes greater limitations on the host country than the model treaties. The proposed treaty prohibits the host country from taxing certain payments from abroad for the purpose of the individual's maintenance, education, study, research, or training. In order to qualify for this exemption, the individual must be a resident of the first country at the beginning of his visit to the other country. The individual's temporary presence in the second country must be for the primary purpose of studying at a university or other accredited educational institution in the second country; securing training required to qualify him to practice a profession or professional specialty; or studying or doing research as a recipient of a grant, allowance, or other similar payments from a governmental, religious, charitable, scientific, literary, or educational organization. In the last case, the treaty prohibits the host country from taxing the grant, allowance, or other similar payments.

The foregoing exemptions apply no longer than the period of time ordinarily necessary to complete the study, training or research. Moreover, no exemption for training or research will extend for a period exceeding five years. The exemption from host country tax does not apply to income from research if the research is undertaken not in the public interest but primarily for the private benefit of a specific person or persons.

The U.S. and OECD model treaties contain similar rules for students and trainees, but not researchers. As noted in the description of Article 1, this article generally will restrict host country tax even if the individual becomes a host country resident for treaty purposes during his visit. Thus, for example, this article may limit U.S. tax on a Russian resident who becomes a U.S. resident during his visit to the United States. No limit would apply, however, if the individual were also a U.S. citizen or obtained immigrant status in the United States.

Article 19. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or Russia. In part, this article is substantially identical to the corresponding article in the U.S. model treaty. In addition, while the proposed treaty has no article specifically directed to the treatment of "gains" (cf. Article 13 of the U.S. and OECD model treaties), Article 19 addresses the taxability of real property gains by the country where the property is located.

As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country will be taxable only in the country of residence. This rule, for example, gives the United States the sole right under the treaty to tax income sourced in a third country and paid to a resident of the United States. This article is subject to the saving clause, so U.S. citizens who are Russian residents would continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to Russia.

The general rule just stated does not apply to income if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment or a fixed base, and income is attributable to the permanent establishment or fixed base. In such a case, the provisions of Article 6 (Business Profits) or Article 13 (Independent Personal Services), as the case may be, will apply. For example, the staff understands that gains from the alienation of property which forms part of the business property of a permanent establishment which an enterprise of one country has or had in the other country, or gains from the alienation of property pertaining to a fixed base available to a resident of one country in the other country for the purpose of performing independent personal services, including gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such a fixed base, may be taxed in that other country. Moreover, it is understood that the proposed treaty does not prevent gains from the alienation by a resident of one country of an interest in a partnership, trust, or estate that has a

permanent establishment situated in the other country from being treated as gain under this paragraph of the treaty. Thus, the proposed treaty permits the United States to tax gain from the disposition of an interest in a partnership that has a U.S. permanent establishment, regardless of whether the partnership interest is an interest in U.S. real property.

The general rule prohibiting taxation by the country other than that of residence does not apply to gains derived by a resident of one treaty country from the alienation of real property situated in the other treaty country. Real property for the purposes of this article means what it means in Article 9 (Income from Real Property). Nor does the prohibition of tax by the second country apply to gains from the alienation of shares or other rights participating in profits in a company whose assets consist not less than 50 percent of real property situated in that country. In such cases the second country may apply its internal law to those gains.

Under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale or exchange of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States (secs. 897 and 1445). "U.S. real property interests" include interests in certain corporations that hold or held U.S. real property. Moreover, under regulations, amounts received in exchange for interests in partnerships, trusts and estates may, to the extent attributable to U.S. real property interests, be considered to be amounts received from the sale or exchange of such real property interests. The proposed protocol specifies that the United States retains the right under the proposed treaty to tax a "U.S. real property interest" as that term is defined in section 897 (or any successor), as well as an interest in a partnership, trust, or estate to the extent attributable to a U.S. real property interest. Thus, the proposed treaty permits the United States to tax transactions of a Russian resident taxable to the extent permitted under FIRPTA.

Article 20. Limitation on Benefits

The proposed treaty contains a provision, not found in the USSR treaty, intended to limit indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in the United States or Russia.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Russia as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as "treaty shopping" and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries which entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts

under favorable conditions (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed new anti-treaty shopping article provides that a person other than an individual (for example, a corporation, partnership, trust, or other business organization) is not entitled to the benefits of the treaty unless it satisfies an ownership/"base erosion" test, a public company test, or an active business test, or unless it is a not-for-profit, tax exempt organization that also satisfies an ownership test. While not stated in the proposed treaty, the Technical Explanation states an understanding that the treaty countries themselves, and their political subdivisions, are also entitled to treaty benefits.

Under the ownership/base erosion payment test, more than 50 percent of the beneficial interest (in the case of a company, more than 50 percent of the number of shares of each class of shares) in that entity must be owned directly or indirectly by any combination of one or more individual residents of Russia or the United States, certain publicly traded companies (as described in the discussion of the public company test below), or certain tax-exempt organizations (as described in the discussion of qualifying organizations below). This rule would, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends or royalties paid to a Russian company that is controlled by individual residents of a third country.

In addition, the ownership/base erosion test is met only if no more than 50 percent of the gross income of the entity is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons or entities other than those just named. The proposed treaty specifies that "gross income" for this purpose means either "gross receipts," or, where a person is engaged in a business which includes the manufacture or production of goods, gross receipts less direct costs of labor and materials attributable to the manufacture or production, and paid or payable out of gross receipts. This rule is commonly referred to as the "base erosion" rule and is necessary to prevent a corporation, for example, from distributing (including paying, in the form of deductible items such as interest, royalties, service fees, or other amounts) most of its income to persons not entitled to benefits under the treaty. This provision is substantially similar to that in recent U.S treaties, although many of these do not define the term "gross income."

Under the public company test, a company that is a resident of Russia or the United States, and whose shares are traded in the residence country on a substantial and regular basis on an officially recognized stock exchange, is entitled to the benefits of the treaty regardless of where its actual owners reside or the amount or destination of payments it makes. The proposed protocol states that, in the United States, the term "officially recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc., and any stock exchange reg-

istered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934.

Under the active business test, treaty benefits will be available under the proposed treaty to an entity that is a resident of the United States or Russia, the ownership/interest payment and public company tests notwithstanding, if it is engaged in the active conduct of a trade or business in its residence country, and the income derived from the other country is derived in connection with, or is incidental to, that trade or business. However, this exception does not apply (and benefits are therefore denied) to the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company. This active trade or business rule replaces a more general rule in some earlier U.S. income tax treaties that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty.

The limitation on benefits article in the U.S.-German income tax treaty has a similar "active business" provision, and is supplemented by a Memorandum of Understanding elaborating on the provision. The memorandum provides several examples of situations in which the active business test would be considered to be met and examples where it would not be met. The Technical Explanation of the proposed Russian treaty indicates that these examples also illustrate the situations covered by the active business provision in the proposed treaty. Under one example, the Memorandum of Understanding as applied to the proposed treaty would indicate that U.S. source interest income on short-term investments of earnings, retained as working capital, of an active Russian business carried on by a Russian company, is incidental to the Russian business and therefore eligible for treaty benefits on that basis. As another example, application of the principles of the Memorandum of Understanding to a case covered by the proposed treaty would indicate that if a third-country resident establishes a Russian company for the purpose of acquiring a large U.S. manufacturing company, and the Russian company's only other activity is the operation of a small retailing outlet which sells products manufactured by the U.S. company, dividends from the U.S. company would not be entitled to benefits. In this case, despite an arguable business connection between the U.S. and Russian businesses, the active Russian business is not substantial in relation to the business of the U.S. subsidiary.

An entity will also be entitled to benefits under the proposed treaty if it is a not-for-profit organization that is generally exempt from income taxation in its treaty country of residence, provided that more than half the beneficiaries, members, or participants, if any, in the organization are entitled to the benefits of the treaty.

Finally, the treaty provides a "safety-valve" for a treaty country resident that has not established that it meets one of the other more objective tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty. Under this provision, such a person may be granted treaty benefits if the competent authority of the source country so determines.

The provision is similar to a portion of the qualified resident definition under the Code branch tax rules, under which the Secretary of the Treasury may, in his sole discretion, treat a foreign corporation as being a qualified resident of a foreign country if the corporation establishes to the satisfaction of the Secretary that it meets such requirements as the Secretary may establish to ensure that individuals who are not residents of the foreign country do not use the treaty between the foreign country and the United States in a manner inconsistent with the purposes of the Code rule.

It appears that any corporation that would satisfy the limitation on benefits article of the proposed treaty would generally also meet the definition of "qualified resident" for branch profits tax purposes in the Code. For example, a Russian corporation qualifies for treaty benefits under the proposed treaty if there is substantial and regular trading of stock on a recognized stock exchange, while that corporation would not meet the 1986 Act's public company test unless such company's stock were *primarily* traded on an established securities market (or the corporation were wholly owned by another corporation whose stock were primarily so traded). It may be that, for practical purposes, those tests could be interpreted in substantially the same fashion. Also, although it is unlikely, a Russian corporation that met the active business test might conceivably fail whatever tests the Secretary promulgated under Code section 884(e)(4)(C).

Article 21. Capital

Many countries, including Russia, have imposed a tax on capital in addition to imposing a tax on income. Under the proposed treaty, capital may be taxed by the country in which located if it is real property owned by a resident of either country, or if it is personal property forming part of the business property of a permanent establishment or fixed base maintained by a resident of the other country. The owner's country of residence could also tax that property. The right to tax ships, aircraft, containers, and related movable property operated in international traffic belongs solely to the country in which the owner resides. All other capital of a resident of a treaty country is taxable only in the residence country.

This article is similar to Article 22 of the U.S.-German income tax treaty and to provisions in the U.S. and OECD model treaties.

Article 22. Relief from Double Taxation

U.S. internal law

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign source income. Russia also has allowed foreign tax credits. Under U.S. law, an indirect or "deemed-paid" credit is also provided. A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have

paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received.

Only income tax (or tax in lieu thereof) is creditable

The foreign tax credit is available only for income, war profits, and excess profits taxes paid or accrued (or deemed paid) to a foreign country or a U.S. possession and for certain taxes imposed in lieu of them (secs. 901(b) and 903). Other foreign levies generally are treated as deductible expenses only. To be creditable, a foreign levy must be the substantial equivalent of an income tax in the U.S. sense, whatever the foreign government that imposes it may call it. To be considered an income tax, a foreign levy must be directed at the taxpayer's net gain.

Treasury regulations promulgated under sections 901 and 903 provide detailed rules for determining whether a foreign levy is creditable (Treas. Reg. secs. 1.901–1 through 1.901–3, and 1.903–1). In general, a foreign levy is creditable only if the levy is a tax and its predominant character is that of an income tax in the U.S. sense. A levy is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country, such as the right to extract petroleum owned by the foreign country. The predominant character of a levy is that of an income tax in the U.S. sense if the levy is likely to reach net gain in the normal circumstances in which it applies and the levy is not conditioned on the availability of a foreign tax credit in another country.

Taxpayers who are subject to a foreign levy and also receive, directly or indirectly, a specific economic benefit from the levying country are referred to as dual capacity taxpayers. Dual capacity taxpayers may obtain a credit only for that portion of the foreign levy that they can establish is a tax and is not compensation for the specific economic benefit received. A taxpayer may so establish that a payment is a tax rather than compensation for a specific economic benefit received, under either a facts and circumstances method or under an elective safe harbor method.

A tax paid in lieu of a tax on income, war profits, or excess profits may constitute a creditable foreign tax. A foreign levy is a creditable tax "in lieu of" an income tax under the regulations only if the levy is a tax and is a substitute for, rather than an addition to, a generally imposed income tax. A foreign levy may satisfy the substitution requirement only to the extent that it is not conditioned on the availability of a foreign tax credit in another country.

Not all U.S. tax may be offset by credit

A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. Moreover, the foreign tax credit provisions contain rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee.

The foreign tax credit limitation is generally computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income, subject to the separate limitation rules discussed above. The limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the averaging of foreign taxes on certain types of traditionally high-taxed foreign source income against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income (Code sec. 907). Amounts claimed as taxes paid on such income qualify as creditable taxes (if they otherwise so qualify) only to the extent they do not exceed the product of highest U.S. corporate tax rate times the amount of that income. Excess amounts generally are neither creditable or deductible, except to the extent that they may be carried over to another year.

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit alternative minimum tax (determined without regard to the net operating loss deduction). However, no such limitation will be imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met. The 90-percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

Proposed treaty provisions

Part of the potential for double tax is dealt with in other articles that limit the right of a source country to tax income. Article 22 contains language stating that in accordance with the provisions of and subject to the limitations of the law of each treaty country (as it may change from time to time without changing the "general principle hereof"), each country is to allow its residents (and, in the case of the United States, its citizens) a credit against its income tax for the income tax paid to the other country by its residents (and, in the case of the United States, its citizens).

Because the operation of Article 22 is conditioned upon the limitations of internal law, it has no operative effect beyond the terms of present law. The proposed protocol, on the other hand, sets forth three additional provisions that affect the allowance of foreign tax credits by the United States. The first provision is an understanding with regard to the credits allowed to a U.S. citizen who is a resident of Russia. The second and third provisions restrict Russian taxes in a way intended to affect the analysis as to whether such taxes are creditable income taxes under U.S. law.

U.S. citizens resident in Russia

As discussed in Part III of this pamphlet, the United States taxes U.S. citizens on their worldwide income. It taxes U.S. residents who are not U.S. citizens in a similar fashion. Only for those indi-

viduals not U.S. citizens or residents does the United States limit its tax jurisdiction to income with a geographical nexus to the United States. With only limited exceptions the treaty does not interfere with the application of internal U.S. tax law to U.S. citizens.

Russia may also tax Russian residents on their worldwide income. Without taking into account foreign tax credits, a U.S. citizen resident in Russia thus is subject to income tax by both countries on U.S. source income, Russian source income, and third country income. In this case the U.S. income tax on the latter two categories of income is imposed solely by reason of the taxpayer's citizenship; without that citizenship, the nature of the taxpayer's residence and the geographical nexus of the income is insufficient to give rise to a U.S. tax.

The proposed protocol states the understanding of the parties with regard to amount of credit Russia will give (for U.S. income taxes) against the taxpayer's Russian tax liability in such a case. It is understood that Russia generally will give a credit for the U.S. tax imposed solely by reason of citizenship. However, this credit is only allowed against the Russian tax that would otherwise be imposed on non-Russian source income. Thus, for example, if a U.S. citizen resident in Russia has German source income, it is understood that the U.S. may collect and retain U.S. tax on that German source income, and Russia will allow a credit for that U.S. tax against the Russian income tax that might otherwise be imposed on the German source income.

Limitations on Russian tax

To be creditable under the limitations of U.S. law, a foreign tax must be directed at the taxpayer's net gain. Like any foreign tax, the Russian tax imposed under the law "on Taxes on Profits from Enterprises and Organizations" (the entity profits tax) has been imposed on a base that is not necessarily identical to the U.S. income tax base. For example, in the past, in order to calculate taxable profit under this Russian law, gross profit was generally increased by certain labor costs in excess of a ceiling, determined annually by the executive and legislative arms of the Russian government. For 1992, this in effect may have resulted in a labor deduction cap computed by reference to, among other things, the legal minimum wage times four. However, this cap, generally did not apply to foreign legal entities conducting entrepreneurial activity in Russian territory through permanent representatives. In calculating taxable profit under the entity tax, interest deductions have in the past been limited in ways that are significantly more restrictive than U.S. law. In the past, deductions have been denied for non-bank interest, and for interest on loans for terms of more than 12 months. In addition, interest deductions have been limited to the extent of the excess of the interest rate over a ceiling set by law. In order to assist U.S. taxpayers seeking eligibility of Russian taxes for use as credits against U.S. income, the proposed treaty requires Russia to provide interest and labor cost deductions; the proposed treaty does not, on the other hand, guarantee that any Russian tax will be creditable for U.S. purposes.

Entity tax.—For purposes of computing the profits tax on entities, the proposed protocol requires Russia to provide certain interest and labor cost deductions regardless of its internal law. The rule applies to Russian resident entities with at least 30-percent beneficial ownership (taking in account the capital investment of all participants, including residents of Russian, the United States, and third countries) by U.S. residents. If the entity has total corporate capital of at least $100,000 (or the equivalent value in rubles), then the entity shall, in computing the profits tax, be permitted deductions for interest, whether paid to a bank or another person and without regard to the period of the loan, and for actual wages and other remuneration for personal services. In the case of interest, Russian laws may limit the rate of interest that may be deducted so long as the limitation is not less than the London Inter-bank Offered Rate ("LIBOR") plus a reasonable risk premium to be provided for in the loan agreement.

If the Russian law "Tax on Profit from Enterprises and Organizations," or a substantially similar profits tax law, ceases to be in effect, the proposed protocol requires Russia to permit the entity to continue to compute its tax in the manner stipulated in that law, taking into account the proposed protocol's requirement that Russia allow deductions for wages and interest as described above.

Banking, insurance or other financial business tax.—The proposed protocol imposes like restrictions on the imposition of Russian income tax on a banking, insurance or other financial business carried on in Russia by a permanent establishment of a U.S. resident, or by a Russian resident, provided that the taxpayer applies the tax rates in effect in accordance with the law on taxation of profits; that is, the rates in effect under the law on "Tax on Profit from Enterprises and Organizations." Under that law, the tax rate on enterprises and foreign legal entities recently has been generally 32 percent, while the tax rate for exchanges and brokerage offices and also enterprises—on profit from intermediary operations and transactions—is 45 percent. By contrast, under the law "On Taxation of Income of Banks," recently the rate has been generally 30 percent and under the law "On Taxation of Income from Insurance Activities," the rate has been generally 25 percent. Both of those laws may have incorporated to some extent the limits on labor and interest cost deductions provided in the law on tax on profit from enterprises and organizations. If that were the case after the proposed treaty takes effect, then, for example (assuming no changes in the rates listed above), an insurance company would be entitled to the protocol-based deductions only if it elected to have its tax rate on the lower base increased by 7 percentage points.

Article 23. Non-discrimination

The proposed treaty contains a comprehensive nondiscrimination article relating to all taxes of every kind. According to the Technical Explanation, it is intended to apply to all taxes imposed at the national, state, republic, or local level, although unlike the U.S. model, the proposed treaty omits reference to the levels of government at which it is intended to apply. In this respect the proposed treaty is similar to the OECD model treaty, and its interpretation

under the Technical Explanation is similar to that in the Commentary on the OECD model.[12] It is in some ways similar to the nondiscrimination article in the U.S. model treaty and to provisions that have been embodied in other recent U.S. income tax treaties. However, those treaties and the OECD model generally express the principles of nondiscrimination by requiring "national treatment" of treaty country nationals and enterprises. By contrast, the proposed treaty states that it requires both "national treatment" *and a form of "most-favored-nation treatment"* (not taking into account special agreements, such as bilateral income tax treaties, with third countries) to be applied to citizens and residents of the treaty countries. In this respect the proposed treaty is partially similar to the USSR treaty.

In general, under the proposed treaty, one country cannot discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on citizens of the other country than it would impose on its citizens, or citizens of a third country, in the same circumstances. This provision applies whether or not the citizen in question is a resident of the United States or Russia. However, like the corresponding provision of the USSR treaty, this provision is not to be construed to oblige one country to grant citizens of the other country tax benefits granted by special agreement to citizens of a third country. Thus, if an aspect of Russian internal law taxes foreign citizens more favorably than similarly situated Russian citizens, the treaty obligates Russia to afford the more favorable treatment to U.S. citizens as well. By contrast, if a special agreement (e.g., a bilateral income tax treaty) affords the citizens of a third country in like circumstances still *more* favorable treatment, the proposed treaty does not obligate Russia to extend such treatment to U.S. citizens.

By the express terms of the U.S. model, a U.S. citizen who is not a resident of the United States and a Russian citizen who is not a resident of the United States would not be deemed to be in the same circumstances. Such language does not appear in the proposed treaty. However, the Technical Explanation states an understanding that, for U.S. tax purposes, the non-discrimination article does not obligate the United States to subject an individual who is a Russian citizen not resident in the United States to the same taxing regime as that applied to a U.S. citizen not resident in the United States. Moreover, the Technical Explanation states the understanding that, consistent with language in the U.S. and OECD model treaties that is absent in the proposed treaty, neither country is required to grant residents of the other country the same personal exemptions and deductions that it provides to its own residents to take account of marital status or family responsibilities.

Under the proposed treaty, neither country may impose, on income attributable to a permanent establishment of a resident of the other country, taxes more burdensome than those are generally imposed on its own residents or third-country residents carrying on the same activities. This provision is not to be construed to oblige either country to grant permanent establishments of residents of

[12] Paragraph 60, Commentary to article 24 of the OECD model.

the other country any tax benefits granted by special agreement to permanent establishments of residents of a third country.

Each country is required (subject to the arm's-length pricing rules of Articles 7(1) (Adjustments to Income in Cases Where Persons Participate, Directly or Indirectly, in the Management, Control or Capital of Other Persons), 11(4) (Interest), and 12(4) (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Technical Explanation indicates that the term "other disbursements" is understood to include a reasonable allocation of executive and administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises. For purposes of capital taxes, debts that are owed to a resident of the other country are to be deductible under the same conditions that would apply if the debts were owed to a resident of the country of residence of the obligor.

The rule of nondiscrimination also applies to residents of one country owned in whole or in part by residents of the other country. A company resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, will not be subjected in the first country to any taxation or any connected requirement which is more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar resident companies (whether owned by residents of the first country or residents of a third country).

The saving clause (which allows the country of residence, citizenship, or former citizenship to tax notwithstanding certain treaty provisions) does not apply to the nondiscrimination article.

Article 24. Mutual Agreement Procedure

The proposed treaty contains the standard U.S. model treaty mutual agreement provision, with some variation, which authorizes the competent authorities of the United States and Russia to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under this article, a resident of one country who considers that the action of one or both of the countries will cause him to pay a tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or citizen. The competent authority will then make a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, then that competent authority will endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the treaty. The provision requires a waiver of the statute of limitations of either country so as to permit the issu-

ance of a refund or credit notwithstanding the statute of limitations.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty.

Like the U.S. model treaty, the proposed treaty makes express provision for competent authorities to mutually agree on the allocation of income, deductions, credits, or allowances, the determination of the source of income, the characterization of particular items of income, the common meaning of a term, the application of penalties, fines, and interest under internal law, and the elimination of double taxation in cases not provided for in the treaty.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. This provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the treaty. It also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Russia.

Article 25. Exchange of Information

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can properly administer the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or of the domestic laws of the two countries concerning taxes to which the treaty applies insofar as the taxation under those domestic laws is not contrary to the treaty. The exchange of information is not restricted by Article 1 (General Scope). Therefore, third-country residents will be covered. In addition, the exchange of information applies to all national taxes imposed by either country, whether or not covered by the treaty.

Any information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the treaty applies. Such persons or authorities can use the information for such purposes only. As indicated in the Technical Explanation, persons involved in the administration of taxes include legislative bodies, such as, for example, the tax-writing committees of Congress and the U.S. General Accounting Office, for use in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

The proposed treaty contains limitations on the obligations of the countries to supply information. A country is not required to carry out administrative measures at variance with the law and adminis-

trative practice of either country, or to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Upon an appropriate request for information, the requested country is to obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. A requested country is to use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country. Staff understands that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that the provision be strictly reciprocal. For example, once the Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the U.S. investigators can no longer use an administrative summons to obtain information. If, however, Russia could still use administrative processes to obtain requested information, it would be expected to do so even though the United States could not. The United States could not, however, tell Russia which of its procedures to use.

Where specifically requested by the competent authority of one country, the competent authority of the other country shall, if possible, provide the information in the form requested. Specifically, the competent authority of the second country will provide depositions of witnesses and authenticated copies of complete original documents (including books, papers, statements, accounts, and writings) to the extent that they can be obtained under the laws and practices of the second country in the enforcement of its own tax laws.

The exchange of information provisions of the proposed treaty reflects in large part the comparable provisions of the U.S. model treaty, which provisions are generally absent from the USSR treaty. However, the proposed treaty omits the provision of the U.S. model treaty that obligates the countries are to endeavor to collect such tax on behalf of the other country as may be necessary to ensure that benefits of the treaty are not going to persons not entitled to those benefits.

Article 26. Members of Diplomatic Missions and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply in full to this article, so that, for example, U.S. diplomats who are considered Russian residents may generally be protected from Russian tax.

Article 27. Entry Into Force

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country and the instruments of ratification are to be exchanged as soon as possible. The proposed treaty will enter into force when the instruments of ratification are exchanged. With regard to withholding taxes on dividends, interest or royalties, the proposed treaty will take effect for amounts paid or credited on or after the first day of the second month following the month in which the treaty enters into force. With respect to other taxes, the proposed treaty will take effect for taxable periods beginning on or after the first of January following the date of entry into force.

In general, the USSR treaty ceases to have effect once the proposed treaty enters into force. Given that there will be in general be some gap between the date that the treaty enters into force and the date that it takes effect with respect to any particular tax, the Technical Explanation clarifies that it was the intention of the negotiators that provisions of the USSR treaty will continue to have effect up until the date that the corresponding provisions of the proposed treaty take effect. A taxpayer may elect instead to be taxed under the USSR treaty (in its entirety) for the first taxable year with respect to which the proposed treaty would otherwise be in effect. It is anticipated that this election will not be relevant to a taxpayer that might be subject to gross-basis withholding tax on dividends, interest, or royalties under either the USSR treaty or the proposed treaty, in light of the more favorable rules under the proposed treaty.

Article 28. Termination

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it at any time after five years from the date of its entry into force, by giving at least six months prior written notice through diplomatic channels.

With respect to taxes withheld at source, a termination will be effective for amounts paid or credited on or after the first of January following the expiration of the six-month period. With respect to other taxes, a termination is to be effective for taxable years beginning on or after the first of January following the expiration of the six-month period.

○